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## CIVIL PROCEDURE—PRE-TRIAL DISCOVERY OF EXISTENCE AND AMOUNT OF DEFENDANT'S LIABILITY INSURANCE POLICY\*

### I. INTRODUCTION AND GENERAL BACKGROUND

Following an automobile accident the average claimant, after assessing the amount of his loss, usually asks the other party(ies) involved, "Do you have insurance?" Next follows, "How much?" To him these questions are not unusual, nor does he see anything wrong in asking them. There is, however, a clear divergence of opinion among commentators<sup>1</sup> and federal<sup>2</sup> and state

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\* *Slomberg v. Pennabaker*, 42 F.R.D. 8 (M.D. Pa. 1967); *Ellis v. Gilbert*, 19 Utah 2d 189, 429 P.2d 39 (1967).

1. See 2A W. BARRON & A. HOLTZOFF, *FEDERAL PRACTICE AND PROCEDURE, RULES EDITION* 647.1 (1961); Fournier, *Pre-Trial Discovery of Insurance Coverage and Limits*, 28 *FORDHAM L. REV.* 215 (1959); Frank, *Discovery and Insurance Coverage*, 1959 *INS. L.J.* 281; Lavorci, *Discovery of Insurance Policy Limits*, 6 *DE PAUL L. REV.* 225 (1956-1957); Thode, *Some Reflections on the 1957 Amendments to the Texas Rules of Civil Procedure Pertaining to Witnesses at Trial, Depositions, and Discovery*, 37 *TEX. L. REV.* 33, 40-42 (1958); Williams, *Discovery of Dollar Limits in Liability Policies in Automobile Tort Cases*, 10 *ALA. L. REV.* 355 (1958); 39 *N.D.L. REV.* 107 (1963); 9 *OKLA. L. REV.* 412 (1956).

2. In the following federal district courts discovery of such information has been allowed: District of Columbia, *Cook v. Welty*, 253 F. Supp. 875 (D.D.C. 1966); Hawaii, *Furumizo v. United States*, 33 F.R.D. 18 (D. Hawaii 1963); Kansas, *Ash v. Farwell*, 37 F.R.D. 553 (D. Kan. 1965); Western District of Kentucky, *Hurt v. Cooper*, 175 F. Supp. 712 (W.D. Ky. 1959); Montana, *Schwenner v. White*, 199 F. Supp. 710 (D. Mont. 1961); *Johanek v. Aberle*, 27 F.R.D. 272 (D. Mont. 1961); Southern District of New York, *Orgel v. McCurdy*, 8 F.R.D. 585 (S.D.N.Y. 1948); Southeastern District of North Dakota, *Hodges v. Heap*, 40 F.R.D. 314 (S.E.D.N.D. 1966); Oregon, *Hurley v. Schmid*, 37 F.R.D. 1 (D. Ore. 1965); Middle District of Pennsylvania, *Slomberg v. Pennabaker*, 42 F.R.D. 8 (M.D. Pa. 1967). Those federal district courts in which discovery has been denied are: Eastern District of Illinois, *Gallimore v. Dye*, 21 F.R.D. 283 (E.D. Ill. 1958); Southern District of Illinois, *Roembke v. Wisdom*, 22 F.R.D. 197 (S.D. Ill. 1958); Eastern District of New York, *Di Biase v. Rederi A/B Walship*, 32 F.R.D. 41 (E.D.N.Y. 1963); Northern District of Ohio, *McDaniel v. Mayle*, 30 F.R.D. 399 (N.D. Ohio 1962); Eastern District of Pennsylvania, *McClure v. Boeger*, 105 F. Supp. 612 (E.D. Pa. 1952), *reviewed*, 32 *NEB. L. REV.* 106 (1952); Western District of Pennsylvania, *Rosenberger v. Vallejo*, 30 F.R.D. 352 (W.D. Pa. 1962). In three districts different judges have reached divergent results. Discovery was denied in Connecticut in *Langlois v. Allen*, 30 F.R.D. 67 (D. Conn. 1962) and *Flynn v. Williams*, 30 F.R.D. 66 (D. Conn. 1958) but allowed in *Novak v. Good Will Grange No. 127, Patrons of Husbandry, Inc.*, 28 F.R.D. 394 (D. Conn. 1961). In New Jersey discovery was denied in *Bisserier v. Manning*, 207 F. Supp. 476 (D.N.J. 1962) but permitted in *Hill v. Greer*, 30 F.R.D. 64 (D.N.J. 1961). Discovery was allowed in the Eastern District of Tennessee in *Brckett v. Woodall Food Prods.*, 12 F.R.D. 4 (E.D. Tenn. 1951) but not permitted in *Cooper v. Stender*, 30 F.R.D. 389 (E.D. Tenn. 1962), *Hillman v. Penny*, 29 F.R.D. 159 (E.D. Tenn. 1962), and *McNelly v. Perry*, 18 F.R.D. 360 (E.D. Tenn. 1955).

courts<sup>3</sup> with respect to the discoverability of liability insurance and its limits; *i.e.*, whether a claimant in an automobile collision case can require the defendant to disclose his liability insurance and its policy limits.

Generally, when a relationship between the provisions of the insurance policy and the issues in dispute can clearly be shown, the terms of the defendant's liability insurance are discoverable. Discovery is allowed to disclose the relationship of the parties (*e.g.*, master-servant), the ownership of property, or previous accidents.<sup>4</sup> The relevancy of policy provisions is apparent in these cases. The problem arises when this relevancy cannot be so clearly established.

Rules 33 and 26(b) of the Federal Rules of Civil Procedure prescribe the relevancy standard in the federal courts. State relevancy standards appear under statutes or rules of court in jurisdictions with Federal Rules analogues.<sup>5</sup> Rule 33 states, that "[i]nterrogatories may relate to any matter which can be inquired into under Rule 26(b)."<sup>6</sup> Rule 26(b) provides:

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3. In the following states discovery has been allowed: Alaska, *Miller v. Harpster*, 392 P.2d 21 (Alaska 1964), *noted in* 40 WASH. L. REV. 347 (1965); California, *Superior Ins. Co. v. Superior Ct.*, 37 Cal. 2d 749, 235 P.2d 833 (1951) and *Laddon v. Superior Ct.*, 167 Cal. App. 2d 391, 334 P.2d 638 (1959), *reviewed*, 6 U.C.L.A.L. REV. 693 (1959); Colorado, *Lucas v. District Ct.*, 140 Colo. 510, 345 P.2d 1064 (1959), *reviewed*, 31 ROCKY MT. L. REV. 387 (1959); Illinois, *People ex rel. Terry v. Fisher*, 12 Ill. 2d 231, 145 N.E.2d 588 (1957); Kentucky, *Maddox v. Grauman*, 265 S.W.2d 939 (Ky. 1954); Utah, *Ellis v. Gilbert*, 19 Utah 2d 189, 429 P.2d 39 (1967). States which have denied discovery are: Arizona, *Di Pietruntonio v. Superior Ct.*, 84 Ariz. 291, 327 P.2d 746 (1959); Connecticut, *Verrastro v. Grecco*, 21 Conn. Supp. 165, 149 A.2d 703 (1965) (Connecticut has discovery rules narrower than federal rules); Delaware, *Ruark v. Smith*, 51 Del. 420, 147 A.2d 514 (1959), *noted in* 10 MERCER L. REV. 333 (1959); Florida, *Brooks v. Owens*, 97 So. 2d 693 (Fla. 1957), *reviewed*, 44 VA. L. REV. 623 (1958) and 34 N.D.L. REV. 165 (1958); Idaho, *Sanders v. Ayhrhart*, 89 Idaho 302, 404 P.2d 589 (1965), *reviewed*, 17 S.C.L. REV. 750 (1965); Minnesota, *Jeppeson v. Swanson*, 243 Minn. 547, 68 N.W.2d 649 (1955), *reviewed*, 40 MINN. L. REV. 183 (1956); Missouri, *State ex rel. Bush v. Elliott*, 363 S.W.2d 231 (Mo. 1963); Montana, *State ex rel. Hersman v. District Ct.*, 142 Mont. 139, 381 P.2d 799 (1963); Nebraska, *Mecke v. Bahr*, 177 Neb. 584, 129 N.W.2d 573 (1964); Nevada, *State ex rel. Allen v. Second Judicial Dist. Ct.*, 69 Nev. 196, 245 P.2d 999 (1952) (Nevada's discovery rules are less liberal than the federal rules); Oklahoma, *Carmen v. Fishel*, 418 P.2d 963 (Okla. 1966) and *Peters v. Webb*, 316 P.2d 170 (Okla. 1957); South Dakota, *Bean v. Best*, 76 S.D. 462, 80 N.W.2d 565 (1957) (South Dakota has discovery rules less liberal than the federal rules).

4. 4 J. MOORE, FEDERAL PRACTICE § 26.16[3], at 1189 (2d ed. 1966).

5. *Gallimore v. Dye*, 21 F.R.D. 283 (E.D. Ill. 1958); *Ruark v. Smith*, 51 Del. 420, 147 A.2d 514 (1959); 4 J. MOORE, FEDERAL PRACTICE § 26.16[3], at 1189 (2d ed. 1966).

6. FED. R. CIV. P. 33.

Unless otherwise ordered by the court as provided by Rule 30(b) or (d), the deponent may be examined regarding any matter, not privileged, which is relevant to the subject matter involved in the pending action, whether it relates to the claim or defense of the examining party or to the claim or defense of any other party, including the existence, description, nature, custody, condition and location of any books, documents, or other tangible things and the identity and location of persons having knowledge of relevant facts. It is not ground for objection that the testimony will be inadmissible at the trial if the testimony sought appears reasonably calculated to lead to the discovery of admissible evidence.<sup>7</sup>

Those courts denying discovery of liability insurance have generally given a strict construction to the rule, while those allowing it broaden its scope.

Two recent cases, *Slomberg v. Pennabaker*,<sup>8</sup> decided in a federal court, and *Ellis v. Gilbert*,<sup>9</sup> a state case, ruled on the general problem of discoverability of liability insurance. Both held that the defendant must reply in discovery procedure with respect to whether he is insured, the name of the insurer and the limits of the policy. To understand the legal development which led to these results it is necessary to examine the general reasons for allowing or disallowing discovery of liability insurance.

## II. DISCOVERY ALLOWED

Courts and commentators have developed many judicial rules and policy considerations as reasons for allowing discovery of liability insurance by the claimant. Because many of these rules are unrelated they will be considered separately.

(a) Whether or not the matters of the existence, terms, and limits of the automobile liability insurance policy are relevant to the subject matter is the thread which runs through these decisions. The terms of a relevant policy, however, are never disclosed to the jury. Knowledge of the policy's existence would tend to destroy the requirement of fault as the foundation for negligence and likely would lead to extravagant verdicts.<sup>10</sup> This,

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7. FED. R. CIV. P. 26(b).

8. 42 F.R.D. 8 (M.D. Pa. 1967).

9. 19 Utah 2d 189, 429 P.2d 39 (1967).

10. *Kiernan v. Van Schaik*, 347 F.2d 775 (3d Cir. 1965); *Mangino v. Bonsette*, 109 Cal. App. 202, 292 P. 100 (1930).

however, does not preclude its discovery by the claimant, since the test is not whether the information sought would be admissible in evidence but whether it is relevant to the subject matter of the action.<sup>11</sup>

In giving its view of "subject matter" and "relevance" the court in *Ellis v. Gilbert* stated:

In considering what is the "subject matter" of a lawsuit we keep in mind that the ultimate objective of any lawsuit is a determination of the dispute between the parties; and that the earlier and easier this can be accomplished, with justice to both sides, the better for all concerned. Whatever helps to attain that objective is "relevant" to the lawsuit.<sup>12</sup>

(b) Disclosure of insurance will facilitate a realistic appraisal of the case and aid in its preparation. Since the claimant sues to recover money, he is not interested in a paper judgment. Whether the defendant has liability insurance frequently controls trial preparation by the claimant. As one court stated: "That there will be actual rather than nominal recovery conditions every aspect of these cases—investigators, doctors, photographers, and even the taking of depositions."<sup>13</sup>

(c) Disclosure will promote settlement, thereby relieving congested court calendars. Where injuries are extensive but insurance coverage low, the plaintiff might be discouraged from holding out for an amount commensurate with his injuries, but, instead, accept a smaller settlement.<sup>14</sup> With today's congested dockets, largely a result of the increasing number of negligence cases arising out of automobile accidents, the interest of the administration of justice and the interest of the individual litigant are served by these settlements.<sup>15</sup>

11. *E.g.*, *Johanek v. Aberle*, 27 F.R.D. 272 (D. Mont. 1961).

12. 19 Utah 2d 189, 429 P.2d 39, 40 (1967).

13. *People ex rel. Terry v. Fisher*, 12 Ill. 2d 231, 238, 145 N.E.2d 588, 593 (1957); *accord*, *Lucas v. District Ct.*, 140 Colo. 510, 519, 345 P.2d 1064, 1068 (1959).

14. *Cook v. Welty*, 253 F. Supp. 875 (D.D.C. 1966); *Schwentner v. White*, 199 F. Supp. 710 (D. Mont. 1961); *Superior Ins. Co. v. Superior Ct.*, 37 Cal. 2d 749, 235 P.2d 833 (1951).

15. *Cook v. Welty*, 253 F. Supp. 875 (D.D.C. 1966); *People ex rel. Terry*

(d) An insurance policy should be relevant while the action is pending as well as after it is completed. The court in *Maddow v. Grauman*<sup>16</sup> supported this proposition and stated:

If the insurance question is relevant to the subject matter after the plaintiff prevails, why is it not relevant while the action pends? We believe it is. An insurance contract is no longer a secret, private, confidential arrangement between the insurance carrier and the individual but it is an agreement that embraces those whose person or property may be injured by the negligent act of the insured. We conclude the answers to the propounded questions are relevant to the subject matter of the litigation. . . .<sup>17</sup>

(e) The claimant often asserts that the insurance company is the actual defendant. It is the insurance company which takes over the defense of the action, furnishes counsel for the defendant, and conducts such investigation, negotiations and settlement as it believes necessary.<sup>18</sup> Judge Oliver Wendell Holmes recognized the reality of the situation when he stated, "judges need not be more naive than other men."<sup>19</sup> Since the insurance company is in effect substituted as a party, it would seem to be relevant that the plaintiff know of the existence of insurance in order to prepare his case and be aware of his real adversary.<sup>20</sup> Nor is there any reason why the defendant himself should object to allowing discovery. He bought the policy to protect himself and discovery would increase the possibility of settlement within the policy limits.<sup>21</sup>

(f) Through state financial responsibility laws, through other state legislation, and through provisions of the insurance policy itself, courts have found that the benefit of the policy inures to the injured, making it relevant to the subject matter of the

16. 265 S.W.2d 939 (Ky. 1954).

17. *Id.* at 942, quoted in *Ash v. Farwell*, 37 F.R.D. 553, 555 (D. Kan. 1965); *Furumizo v. United States*, 33 F.R.D. 18, 19 (D. Hawaii 1963); *Hurt v. Cooper*, 175 F. Supp. 712, 713 (W.D. Ky. 1959); and *Lucas v. District Ct.*, 140 Colo. 510, 521, 345 P.2d 1064, 1070 (1959).

18. *Cook v. Welty*, 253 F. Supp. 875 (D.D.C. 1966); *Schwentner v. White*, 199 F. Supp. 710 (D. Mont. 1961); *Johanek v. Aberle*, 27 F.R.D. 272 (D. Mont. 1961).

19. *People ex rel. Terry v. Fisher*, 12 Ill. 2d 231, 239, 145 N.E.2d 588, 593 (1957).

20. *Lucas v. District Ct.*, 140 Colo. 510, 345 P.2d 1064 (1959); *People ex rel. Terry v. Fisher*, 12 Ill. 2d 231, 145 N.E.2d 588 (1957).

21. *Slomberg v. Pennabaker*, 42 F.R.D. 8 (M.D. Pa. 1967); *Ellis v. Gilbert*, 19 Utah 2d 189, 429 P.2d 39 (1967).

case and therefore discoverable. Typical of the safety responsibility laws now being widely enacted throughout the United States are those relating to suspension of the driver's license and vehicle registration. If an owner or operator of a vehicle is involved in an accident resulting in personal injury or in property damage exceeding one hundred dollars, suspension of license and registration results unless: (1) within sixty days security can be posted to satisfy claims or (2) the defendant has a liability policy of a minimum statutory amount.<sup>22</sup> Because the liability policy is taken out pursuant to compulsory features of financial responsibility laws, the policy inures to the benefit of every person negligently injured by the insured as completely as if the injured party had been named in the policy. As a result of this public policy of providing compensation for the injured person, a discoverable interest in the policy is created.<sup>23</sup> Several states have statutes making an injured party a third party beneficiary of the policy and allowing discovery on this basis.<sup>24</sup> One district court has held, moreover, that provisions in the policy which permit the plaintiff to proceed against the insurer after obtaining a judgment against the defendant are themselves sufficient to allow discovery of the policy's provisions as relevant to the subject matter of the personal injury action.<sup>25</sup>

Finally, the increase in automobile use and the resulting increase in accidents have occasioned the modern legislative trend, both federal and state, toward increasing the stringency of automotive regulations and protective measures. It is from the tenor and purpose of this legislation that the courts find insurance policies relevant to the subject matter of pending actions arising from accidents covered by these policies.<sup>26</sup>

22. 71 HARV. L. REV. 1167 (1958); *see, e.g.*, S.C. CODE ANN. §§ 46-701 to -750.28 (1962).

23. *See, e.g.*, *Ash v. Farwell*, 37 F.R.D. 553 (D. Kan. 1965); *Johanek v. Aberle*, 27 F.R.D. 272 (D. Mont. 1961); *Superior Ins. Co. v. Superior Ct.*, 37 Cal. 2d 749, 235 P.2d 833 (1951); *Lucas v. District Ct.*, 140 Colo. 510, 345 P.2d 1064 (1959); *People ex rel. Terry v. Fisher*, 12 Ill. 2d 231, 145 N.E.2d 588 (1957). *But see* *Brooks v. Owens*, 97 So. 2d 693 (Fla. 1957).

24. *E.g.*, *Lucas v. District Ct.*, 140 Colo. 510, 345 P.2d 1064 (1959); *People ex rel. Terry v. Fisher*, 12 Ill. 2d 231, 145 N.E.2d 588 (1957). *But see* *Cooper v. Stender*, 30 F.R.D. 389 (E.D. Tenn. 1962).

25. *Schwentner v. White*, 199 F. Supp. 710 (D. Mont. 1961); *cf.* *Johanek v. Aberle*, 27 F.R.D. 272 (D. Mont. 1961).

26. *Brckett v. Woodall Food Prods., Inc.*, 12 F.R.D. 4 (E.D. Tenn. 1951); *accord*, *Lucas v. District Ct.*, 140 Colo. 510, 345 P.2d 1064 (1959).

(g) Many of the cases denying discovery assert that if discovery of insurance coverage were allowed, there would be no reason why the defendant could not be required to disclose other information with regard to his property. Courts allowing discovery stress that liability insurance is not in the same category as other assets, since it was purchased for the sole purpose of protection in the event of litigation.<sup>27</sup>

(h) Most courts agree that the Federal Rules of Civil Procedure, or similar state provisions, should be liberally construed. Full disclosure, stress the advocates of discovery, would promote the function of the rules; "to secure the just, speedy, and inexpensive determination of every action."<sup>28</sup> To allow discovery is the better rule, because it is more in agreement with the object and purpose of the rules of civil procedure. Discovery will tend to eliminate secrets, mysteries and surprise. It will promote the disposition of cases without trial and aid in obtaining just results in the cases which are tried.<sup>29</sup> Not to allow discovery would contravene the purpose of the Federal Rules by requiring two steps in a discovery proceeding where one would suffice.<sup>30</sup> The trial is not a sporting event but a search for truth.<sup>31</sup> As one court stated: "The whole purpose of litigation is to obtain results fair to both sides, not to play a game of hide and seek."<sup>32</sup> The court in *Ash v. Farwell*<sup>33</sup> stated:

It is a strange situation indeed, when under our established rules of civil procedure we emphasize that their avowed purpose is to establish the "truth" and require "full disclosure," while at the same time we treat a policy of liability insurance as though it is so sacrosanct that not even a court

27. 4 J. MOORE, FEDERAL PRACTICE § 26.16[3], at 1189 (2d ed. 1966); see, e.g., *Johanek v. Aberle*, 27 F.R.D. 272 (D. Mont. 1961); *People ex rel. Terry v. Fisher*, 12 Ill. 2d 231, 145 N.E.2d 588 (1957); *Maddox v. Grauman*, 265 S.W.2d 939 (Ky. 1954).

28. FED. R. CIV. P. 1; see, e.g., *Slomberg v. Pennabaker*, 42 F.R.D. 8 (M.D. Pa. 1967).

29. *Ash v. Farwell*, 37 F.R.D. 553 (D. Kan. 1965); *Lucas v. District Ct.*, 140 Colo. 510, 345 P.2d 1064 (1959).

30. *Laddon v. Superior Ct.*, 167 Cal. App. 2d 391, 334 P.2d 638 (1959). Discovery rules eliminate the necessity of ancillary proceedings, which once were the only means of establishing a discoverable interest of the plaintiff in the defendant's policy.

31. *Tiedman v. American Pigment Corp.*, 253 F.2d 803 (4th Cir. 1958).

32. *Slomberg v. Pennabaker*, 42 F.R.D. 8, 11 (M.D. Pa. 1967).

33. 37 F.R.D. 553 (D. Kan. 1965).



of justice may glance at it. Confidence in the courts and in court procedure is not enhanced by this judicial attitude.<sup>34</sup>

### III. DISCOVERY DISALLOWED

The reasons that courts have developed for not allowing discovery of liability insurance are numerous and distinct. As in the previous section they will be discussed separately in subparagraphs.

(a) Like the cases allowing discovery, those denying it turn on the basic issue of relevance. The cases hold that the existence or non-existence of liability insurance has no bearing on the issue of the case; that liability insurance is not evidentiary matter which may be used at trial; that liability insurance is not relevant to the subject matter of the trial; and that liability insurance cannot reasonably lead to discovery of evidence on the issue.<sup>35</sup> *Brooks v. Owens*<sup>36</sup> states that the basic concept of the judicial system is:

to insure to citizens of this state and nation an entry into the courts for the purpose of (1) proving liability for an injury and (2) proving damages occasioned thereby. Limits of insurance carried by a defendant in a cause of action are not relevant to either of those basic purposes.<sup>37</sup>

(b) The argument that the liability of the defendant should be determined without regard to his financial ability is reinforced by the obvious premise that the extent of the plaintiff's injuries will be the same whether or not the defendant carries insurance. The case should be decided on its merits rather than on the fact that the defendant does or does not carry liability insurance. The defendant's liability should first be established; then the aid of the court can be solicited in the collection of judgment.<sup>38</sup>

(c) If insurance can be discovered, it may be argued that all of the defendant's assets available to satisfy a judgment against

34. *Id.* at 555.

35. *Cooper v. Stender*, 30 F.R.D. 389 (E.D. Tenn. 1962); *Langlois v. Allen*, 30 F.R.D. 67 (D. Conn. 1962); *Roembke v. Wisdom*, 22 F.R.D. 197 (S.D. Ill. 1958); *Flynn v. Williams*, 30 F.R.D. 66 (D. Conn. 1958); *Goheen v. Goheen*, 9 N.J. Misc. 507, 154 A. 393 (1931).

36. 97 So. 2d 693 (Fla. 1957).

37. *Id.* at 699.

38. *Gallimore v. Dye*, 21 F.R.D. 283 (E.D. Ill. 1958); *see, e.g., Carmen v. Fishel*, 418 P.2d 963 (Okla. 1966).

him are likewise subject to discovery. Cases denying discovery conclude that liability insurance is but one resource among many which could be used to satisfy a judgment.<sup>39</sup> If discovery were allowed, it would be possible for anyone to ascertain the assets of another by merely filing a complaint against him and submitting interrogatories. A claim could be fabricated for the sole purpose of discovering the assets of the party charged.<sup>40</sup>

In addition to leaving the door open for the individual who might have a phony claim to require anyone to divulge his assets, discovery would enable any scoundrel to force a decent person into a settlement of a possibly invented case. The courts stress that a man's contract should be his own, whomever it be with, and that the rules of civil procedure should not be susceptible to this abuse.<sup>41</sup>

(d) Opponents of discovery argue that discovery actually retards the possibility of settlement. These courts and commentators admit that low policy limits may expedite settlement. They contend, however, that with disclosure of high limits, the value of the plaintiff's case will increase in his eyes in proportion to the amount of coverage, and that he will be encouraged to increase his claim and risk trial before a sympathetic jury.<sup>42</sup> Some courts, moreover, question whether these settlements are within the policy of the Federal Rules at all. Since few tort actions regard the ability to pay as relevant, it should not be assumed that the Federal Rules are intended to alter substantive tort law.<sup>43</sup> Many courts believe that the word "determination" in Rule 1 of the Federal Rules of Civil Procedure and similar state rules refers to the disposition of the action in a manner which the court controls; and that therefore determination by the parties outside the court is not within the scope or purpose of the rules. Courts, therefore, should have no control over settlements.<sup>44</sup>

39. *Hillman v. Penny*, 29 F.R.D. 159 (E.D. Tenn. 1962); *Gallimore v. Dye*, 21 F.R.D. 283 (E.D. Ill. 1958). *Contra*, *Johanek v. Aberle*, 27 F.R.D. 272 (D. Mont. 1961).

40. *Gallimore v. Dye*, 21 F.R.D. 283 (E.D. Ill. 1958).

41. *See, e.g.*, *Ellis v. Gilbert*, 19 Utah 2d 189, 429 P.2d 39 (1967).

42. *Bisserier v. Manning*, 207 F. Supp. 476 (D.N.J. 1962); *Developments in the Law—Discovery*, 74 HARV. L. REV. 940, 1018-20 (1961).

43. 5 STAN. L. REV. 322 (1953); *see* *Cooper v. Stender*, 30 F.R.D. 389 (E.D. Tenn. 1962); *Lucas v. District Ct.*, 140 Colo. 510, 345 P.2d 1064 (1959) (dissenting opinion).

44. *Jeppeson v. Swanson*, 243 Minn. 547, 68 N.W.2d 649 (1955); *accord*, *Brooks v. Owens*, 97 So. 2d 693 (Fla. 1957).

(e) Upon discovery of the defendant's liability insurance provisions the plaintiff is placed at a strategic advantage. Although the law favors compromise settlements, it is not the purpose of discovery rules to give one party an advantage over the other.<sup>45</sup> A dissenting justice in *Lucas v. District Court*<sup>46</sup> stated:

The stance of protective benevolence assumed by the majority opinion clothes a plaintiff in warm winter garb but leaves a defendant nude or at least ill clothed before the frigid stares of his opponents and the public. He can have no modesty. His financial virtues are exposed to public gaze and possible rapacious seizure without proper regard to whether the act is legitimate; i.e., without due regard to his actual negligence.<sup>47</sup>

(f) Many courts denying the disclosure of insurance coverage state that to require such disclosure would violate the defendant's right to privacy and right against unreasonable search and seizure, and would contravene the fifth amendment. Moreover, the fundamental right of the defendant to have his day in court would be curtailed. The possible benefits of discovery do not outweigh the denial of these rights.<sup>48</sup>

(g) Like all matters of procedure, discovery has its limits. Those opposed to discovery, while conceding that the possible value of settlement and reduced court congestion might warrant a liberal construction, contend that the permissible limit is exceeded with disclosure of liability insurance provisions.<sup>49</sup> It is not essential to a liberal construction of procedural rules that there be a change in the practice formerly employed. The word "liberal" does not mean change.

(h) Any advantages the plaintiff may gain through discovery are, in these courts' minds, neither advantages pertinent to the presentation of his case at trial nor advantages which will permit disclosure of information which is the object of discovery

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45. *Cooper v. Stender*, 30 F.R.D. 389 (E.D. Tenn. 1962); *Jeppeson v. Swanson*, 243 Minn. 547, 68 N.W.2d 649 (1955); *State ex rel. Bush v. Elliott*, 363 S.W.2d 631 (Mo. 1963); see, e.g., *Gallimore v. Dye*, 21 F.R.D. 283 (E.D. Ill. 1958); *Ruark v. Smith*, 51 Del. 420, 447 A.2d 514 (1959).

46. 140 Colo. 510, 345 P.2d 1064 (1959).

47. *Id.* at 530, 345 P.2d at 1073.

48. *Gallimore v. Dye*, 21 F.R.D. 283 (E.D. Ill. 1958). For a thorough discussion of the constitutional arguments see 34 NOTRE DAME L. REV. 78 (1958).

49. *Bisserier v. Manning*, 207 F. Supp. 476 (D.N.J. 1962); *Jeppeson v. Swanson*, 243 Minn. 547, 68 N.W.2d 649 (1955).

procedure.<sup>50</sup> The courts admit that the ultimate goal of discovery is to obtain information which may be utilized for the defense or proof of an action. They concede that its purpose is to remove the element of surprise from trials by allowing all information germane to the action to be discovered prior to trial. These courts emphasize, however, that information sought which can have no bearing on the determination of the action on its merits is not within procedural rules. The rules are not intended to supply such information for the personal use of a litigant.<sup>51</sup> "Subject matter" in the rules concerns the issue of liability; and the discovery of the existence of liability insurance, its provisions and limits, is not relevant to the issue of liability and therefore not within the purpose of rules of civil procedure.

#### IV. CONCLUSION

A definite division within the nation's judicial system exists today with respect to whether discovery of liability insurance, its limits and provisions, should be permitted.<sup>52</sup> Joseph P. Jenkins, of the Kansas bar, expressed one approach to the problem:

An analysis of the arguments and contentions, fears and complaints, pure legal reasoning, and some not so pure, and the apparent prejudice and bias for and against insurance companies, and the plaintiffs and defendants in general, which parade across the confused reader's gaze leads one literally to throw up his hands and agree with John Arbuthnot that "Law is a bottomless pit." And indeed it is when the courts reach a problem which on its face should be devoid of innate complexities, but which upon close analysis presents a subject which unfortunately has become incapable of a ready, tolerable, clear, and complete solution. We are disposed to accept reason and clear purpose as the goal of law and cherish the idea that law is the embodiment of intellectual thought, analysis, and reason, tempered with a meaningful portion of justice and plain unfettered common sense. For as Sir Edward Coke said,

50. McClure v. Boeger, 105 F. Supp. 612 (E.D. Pa. 1952).

51. Jeppeson v. Swanson, 243 Minn. 547, 68 N.W.2d 649 (1955); accord, Sanders v. Ayhart, 89 Idaho 302, 404 P.2d 589 (1965); State ex rel. Bush v. Elliott, 363 S.W.2d 631 (Mo. 1963); Carmen v. Fishel, 418 P.2d 963 (Okla. 1966).

52. See, e.g., Di Pietrantonio v. Superior Ct., 84 Ariz. 291, 327 P.2d 746 (1959).

"Reason is the life of the law." But, looking over the inability of the courts to solve uniformly the basically simple uncluttered concept of disclosure, one wonders whether Mr. Bumable's [*sic*] exasperated observation that law is an ass may not have more merit when considered within the present context.<sup>53</sup>

Are there any possible solutions? Judges have observed that, because of the expanding number of judicial positions expressed in this controversy, many courts first determine a result and then choose a position on insurance discovery which fits this result.<sup>54</sup> One court has chosen a middle of the road position. It would allow discovery of insurance in a limited context when liability is admitted and damages are substantial. It would deny discovery when liability is highly disputed.<sup>55</sup> There is a widely supported view to the effect that discovery rules should be extended or liberalized only through legislative amendments.<sup>56</sup> This could possibly take the form of a statutory requirement of the public filing of such documents as insurance policies.<sup>57</sup> New Jersey has followed this approach and has explicitly required in its rules the disclosure of liability or property damage insurance.<sup>58</sup>

Recently the Committee on Rules of Practice and Procedure of the Judicial Conference of the United States presented its preliminary draft of proposed amendments to Rules of Civil Procedure for the United States District Courts Relating to Deposition and Discovery.<sup>59</sup> Contained in this draft is an amendment to Rule 26(b) to allow discovery by a party of the existence and contents of any insurance agreement.<sup>60</sup> These draft

53. Jenkins, *Discovery of Automobile Liability Insurance Limits: Quillets of the Law*, 14 KAN. L. REV. 59, 78 (1965).

54. Di Biase v. Rederi A/B Walship, 32 F.R.D. 41 (E.D.N.Y. 1963); McDaniel v. Mayle, 30 F.R.D. 399 (N.D. Ohio 1962).

55. Rosenberger v. Vallejo, 30 F.R.D. 352 (W.D. Pa. 1962).

56. Hillman v. Penny, 29 F.R.D. 159 (E.D. Tenn. 1962); Brooks v. Owens, 97 So. 2d 693 (Fla. 1957); Sanders v. Ayrhart, 89 Idaho 302, 404 P.2d 589 (1965); Jeppeson v. Swanson, 243 Minn. 547, 68 N.W.2d 649 (1955); Meche v. Bahr, 177 Neb. 384, 129 N.W.2d 573 (1964); State *ex rel.* Allen v. Second Judicial Dist. Ct., 69 Nev. 196, 245 P.2d 999 (1952); accord, Hooker v. Raytheon Co., 31 F.R.D. 120 (S.D. Cal. 1962) (action for wrongful death at sea); Peters v. Webb, 316 P.2d 170 (Okla. 1957) (malpractice suit).

57. *Developments in the Law—Discovery*, 74 HARV. L. REV. 940, 1018-20 (1961).

58. N.J.R. 4:16-2; see Degnan, *Enlarging Kansas Discovery*, 11 KAN. L. REV. 221, 233 (1959).

59. 88 S. Ct. 1 (1968).

60. *Id.* at 15.

amendments have not yet been submitted to or considered by the Judicial Conference or the Supreme Court, and it should be understood that the Court is in no way committed to them.

The problem has not yet arisen in South Carolina. Because either side of the discovery issue can be reasonably argued, it is difficult to determine the future resolution of the issue in this state. It is suggested, however, that perhaps the sounder view is to allow discovery. If the purposes, objectives, and philosophy of the modern discovery rules are to eliminate secrecy and surprise and to secure a just, speedy, and inexpensive determination of every action, should not discovery be allowed when liability insurance exists to protect those seeking such disclosure? Through a liberal interpretation of such words as "relevancy," "issues," and "subject matter," a common sense approach can allow disclosure without straining the judicial conscience.<sup>61</sup> Discovery of the existence, provisions and limits of liability insurance would foster and encourage the execution of judicial proceedings with "candor and honesty and without cunning and deception."<sup>62</sup>

PHILLIP E. WALKER

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61. Jenkins, *Discovery of Automobile Liability Insurance Limits: Quillets of the Law*, 14 KAN. L. REV. 59 (1965).

62. *Ellis v. Gilbert*, 19 Utah 2d 189, 429 P.2d 39, 42 (1967).

## LABOR LAW—A UNION'S RIGHT TO DISCIPLINE ITS MEMBERS THROUGH COURT ENFORCED FINES\*

The United Auto Workers Union, bargaining agent for employees at two Allis-Chalmers Manufacturing Company plants in Wisconsin, called strikes at both plants in support of new contract demands. During the course of the strikes, members of the Union crossed the picket lines and returned to work. This conduct violated the Union's constitution and by-laws.<sup>1</sup> After the strikes ended, formal charges of conduct unbecoming a union member were brought against the offenders. At a hearing before a union trial committee, fines ranging from \$20.00 to \$100.00 were levied against the strike violators. The Union brought an action against one of the members in a Wisconsin state court to collect the fine and obtained a judgment in its favor. Allis-Chalmers immediately filed charges with the National Labor Relations Board, claiming that the fines were unfair labor practices under Section 8(b)(1)(A) of the National Labor Relations Act. This section forbids unions to "restrain or coerce" employees in the exercise of their rights granted by Section 7 to "refrain from concerted union activity."<sup>2</sup> The Board dismissed the complaint,<sup>3</sup> and a three-judge panel of the Seventh Circuit affirmed. On rehearing en banc the Seventh Circuit reversed the Board's decision finding the Union guilty of an 8(b)(1)(A) violation.<sup>4</sup> The United States Supreme Court, in a 5-4 decision, reversed the Seventh Circuit and held that court enforced fines fell within the protection of the proviso to Section 8(b)(1)

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\* NLRB v. Allis-Chalmers Mfg. Co., 388 U.S. 175 (1967).

1. The Constitution and by-laws of the Union provided that such action constituted conduct unbecoming a union member and that each violation was punishable by fines up to \$100.00. Local 248, UAW (Allis-Chalmers Mfg. Co.), 149 N.L.R.B. 67, 75 (1964).

2. See National Labor Relations Act §§ 7, 8(b)(1)(A), 29 U.S.C. §§ 157, 158(b)(1)(A) (1964). The relevant portions of the Act are:

§ 157[7] Employees shall have the right . . . to engage in . . . concerted activities . . . and shall also have the right to refrain from any or all such activities . . . .

§ 158(b)(1)(A) [8(b)(1)(A)] It shall be an unfair labor practice for a labor organization or its agents—

(1) to restrain or coerce (A) employees in the exercise of the rights guaranteed in section 157[7] of this title: *Provided*, That this paragraph shall not impair the right of a labor organization to prescribe its own rules with respect to the acquisition or retention of membership therein . . . .

3. Local 248, UAW (Allis-Chalmers Mfg. Co.), 149 N.L.R.B. 67 (1964).

4. Allis-Chalmers v. NLRB, 358 F.2d 656 (7th Cir. 1966).

(A) since they were directed at the regulation of internal union affairs.<sup>5</sup> To understand this decision it would be helpful to review briefly the legislative background of 8(b)(1)(A) and its intended purpose.

The National Labor Relations Act (NLRA) was an attempt by Congress to curb employer abuse by guaranteeing to employees the right to engage in concerted activity in self-organization and collective bargaining.<sup>6</sup> Later the need for similar control of union activities was recognized and the result was the Taft-Hartley amendments. Section 8(b)(1)(A) was incorporated as an amendment primarily to give employees the equal right to refrain from the concerted activities guaranteed by Section 7 of the NLRA.<sup>7</sup> This amendment was basically aimed at prohibiting physical violence and job discrimination by unions against their members.<sup>8</sup> Senator Robert Taft, a leading proponent of the amendment, attributed a broader purpose to its application. He asserted that the section should be analogous to Section 8(a)(1)<sup>9</sup> which prohibits interference by an employer with an employee's Section 7 rights.<sup>10</sup> This general interpretation of 8(b)(1)(A) has been acknowledged by the Supreme Court in *International Ladies' Garment Workers v. NLRB*.<sup>11</sup> The Court in its discussion of the section stated:

It was the intent of Congress to impose upon Unions the same restrictions which the Wagner Act imposed on employers with respect to violations of employee rights.<sup>12</sup>

Neither this case nor legislative history, however, answers specifically whether Section 8(b)(1)(A) proscribes union disciplinary fines.<sup>13</sup> In order to evaluate the *Allis-Chalmers* decision, therefore, it will be useful to examine the treatment of other 8(b)(1)(A) questions.

5. *NLRB v. Allis-Chalmers Mfg. Co.*, 388 U.S. 175 (1967).

6. National Labor Relations Act, § 7, 49 Stat. 449 (1935).

7. 93 CONG. REC. 4016 (1947) (remarks of Senator Ball).

8. *NLRB v. Drivers Local 639*, 362 U.S. 274, 285-87 (1960).

9. 93 CONG. REC. 4021 (1947).

10. 29 U.S.C. § 158(a)(1) (1964). For example, if *Allis-Chalmers* in the above case had taken away the insurance benefits of those employees on strike, this would have clearly been a violation of 8(a)(1).

11. 366 U.S. 731 (1961).

12. *Id.* at 738.

13. See Comment, *8(b)(1)(A) Limitations Upon Right of a Union to Fine its Members*, 115 U. PA. L. REV. 47 (1966) (An analysis reaching the conclusion that history indicates that 8(b)(1)(A) should proscribe union disciplinary fines). But see 94 ILL. B.J. 832 (1966).



The prohibitions embodied in Section 8(b)(1)(A) have caused the judiciary and the National Labor Relations Board considerable difficulty when brought into conflict with the section's proviso. This proviso reserves to the union the right "to prescribe its own rules with respect to the acquisition or retention of membership."<sup>14</sup> Judicial interpretation of the conflict between union violation of 8(b)(1)(A) and union power under the proviso has been far from uniform. Certain union conduct, however, has consistently been brought within its prohibitions without piercing the proviso's protection. An 8(b)(1)(A) violation is clearly established if a union resorts to violence, threats or physical harm to force compliance with its rules.<sup>15</sup> A union is also prohibited from enforcing rules which have a direct effect upon the employment status of a member. A union, therefore, may not cause an employer to interfere with a member's job rights<sup>16</sup> nor promote threats of discharge or actual loss of employment.<sup>17</sup>

With equal consistency, however, courts have refused to find 8(b)(1)(A) violations when the union seeks to discipline its members for rule infractions through threats of suspension or actual expulsion from the union.<sup>18</sup> This union conduct is squarely within the proviso's "acquisition or retention of membership,"<sup>19</sup> protective language.

The cases involving union disciplinary fines have caused the greatest judicial conflict between 8(b)(1)(A) and its proviso. Courts have used a variety of policy arguments in attempting to balance the rights granted to individual union members by Section 7 with the right of the unions to maintain discipline within their ranks.

In *Perry Norvell Company*<sup>20</sup> the NLRB briefly stated its position on the question of union fines. "[I]n that Section, 158

14. 29 U.S.C. § 158 (b)(1)(A) (1964).

15. *E.g.*, *United Steel Workers of America*, 153 N.L.R.B. 1561 (1965); *Painters Dist. Council Local 725*, 97 N.L.R.B. 654 (1951), *enforced*, 202 F.2d 957 (6th Cir. 1952) (mem.), *cert. denied*, 345 U.S. 995 (1953).

16. *E.g.*, *Pacific Intermountain Express Co.*, 110 N.L.R.B. 96 (1954), *enforced*, 228 F.2d 170 (8th Cir. 1955), *cert. denied*, 351 U.S. 952 (1956).

17. *E.g.*, *A. O. Smith Corp. v. NLRB*, 343 F.2d 103, 115 (7th Cir. 1965); *Majestic Molded Prods., Inc.*, 143 N.L.R.B. 71 (1963), *enforced*, 330 F.2d 603 (2d Cir. 1964); *Minneapolis Star & Tribune Co.*, 109 N.L.R.B. 727 (1954).

18. *Price v. NLRB*, 373 F.2d 443 (9th Cir. 1967); *American Newspaper Publishers Ass'n v. NLRB*, 193 F.2d 782 (7th Cir. 1951), *aff'd on other grounds*, 345 U.S. 100 (1952).

19. 29 U.S.C. § 158(b)(1)(A) (1964).

20. 80 N.L.R.B. 225 (1948).

(b)(1)(A) [8(b)(1)(A)] Congress was aiming at means, not at ends.<sup>21</sup> The Board, in other words, has looked at the method of enforcing discipline for violations of a union rule, rather than the rule itself.<sup>22</sup> Moreover, while freely admitting that fines are coercive,<sup>23</sup> the Board has concerned itself primarily with whether this form of disciplinary action affected the employees' employment status.<sup>24</sup> This rather narrow approach has caused confusion in some recent decisions concerning the balancing of individual rights with union security.

In *Local 283, UAW (Wisconsin Motor Corp.)*<sup>25</sup> the union had imposed a ceiling on piecework production and members who exceeded the ceiling were subject to fines up to \$100.00. The Board held that such fines concerned the employee only in his relationship with the union, and not his employment status. The fines were a regulation of internal union affairs and within the protection of the proviso. However, in *Local 138, International Union of Operating Engineers (Charles S. Skura)*<sup>26</sup> a case decided a few months later, the Board found the union guilty of an 8(b)(1)(A) violation when it fined an employee for filing unfair labor practice charges against the union. The Board based its decision on the policy argument that it was in the public interest for an employee to have free access to Board procedure. The Board stated further:

There can be no doubt . . . that the imposition of a fine by a labor organization upon a member who files charges with the Board does restrain and coerce that member in the exercise of his right to file charges. The union's conduct is no less coercive where the filing of the charge is *alleged to be in conflict with an internal union rule or policy and the fine is imposed allegedly to enforce that internal policy.*<sup>27</sup>

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21. *Id.* at 239.

22. *See, e.g., Local 248, UAW (Allis-Chalmers Mfg. Co.)*, 149 N.L.R.B. 67, 70 (1964).

23. *Amalgamated Clothing Workers Local 479*, 151 N.L.R.B. 555 (1965); *Peerless Tool & Eng'r Co.*, 111 N.L.R.B. 853 (1955).

24. *Id.*

25. 145 N.L.R.B. 1097 (1964).

26. 148 N.L.R.B. 679 (1964).

27. *Id.* at 682 (emphasis added).

This was an apparent departure from the test used in *Wisconsin Motors*, and the *Skura* decision has been followed in later cases in which the same question was presented.<sup>28</sup>

In considering the question presented in *Allis-Chalmers*, however, the Board utilized the approach it had previously taken in *Wisconsin Motors*. Failing to find an 8(b)(1)(A) violation, it stated:

[T]he Respondents have properly maintained the distinction between treatment of the individual as a member of the Union and treatment of him as an employee. They have imposed the fine only on their own members.<sup>29</sup>

The Board, therefore, seems to value the right of a union to maintain internal discipline through the imposition of fines more than the right of an individual to cross a picket line and return to work. In contrast the Board favors an individual's right to seek redress by filing unfair labor practice charges.

Unlike the Board, the Seventh Circuit's balancing of interests in *Allis-Chalmers* showed a greater concern for the protection of individual rights. The majority en banc of the Seventh Circuit did not find it necessary to resort to legislative history in order to reach its conclusion that the Union's conduct was an unfair labor practice. The majority read Section 8(b)(1)(A) as clearly indicating that union members who crossed a picket line were exercising their rights under Section 7.<sup>30</sup> The court asserted, moreover, that the imposition of a substantial fine could easily result in a far greater threat to an individual than expulsion from the Union or actual loss of employment.

Attention was directed to the fact that there was a union security clause in existence at both plants involved, which required an employee, as a condition of employment, to join the union within thirty days after being hired. The majority reasoned that, because this requirement destroyed voluntary choice, an employee should be afforded even greater protection from coercive union conduct. The court found that the fines had a direct influence upon a member's employment status and could not be said to relate only to the Union's internal affairs. Conse-

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28. *American Bakery & Confectionary Workers Local 300*, 167 N.L.R.B. 76 (1967); *Wood, Wire & Metal Lathers Local 238*, 156 N.L.R.B. 997 (1966).

29. *Local 248, UAW (Allis-Chalmers Mfg. Co.)*, 149 N.L.R.B. 67, 69 (1964).

30. *Allis-Chalmers Mfg. Co. v. NLRB*, 358 F.2d 656, 660 (7th Cir. 1966).

quently, the fines imposed violated 8(b)(1)(A) and were outside the protection of the proviso. Although not essential to its holding, the court recognized that an overall study of the legislative history of the Taft-Hartley Act revealed a clear intent on the part of Congress "to balance the national labor policy by placing limitations on coercive union conduct similar to those previously prescribed for employers."<sup>31</sup>

In *Allis-Chalmers*<sup>32</sup> the Supreme Court was presented with an opportunity to clear up the uncertainty and conflict in balancing the underlying policy interests that collided when a union fined its members. The majority of the Court easily dismissed the holding of the Seventh Circuit, stating that the wording of 8(b)(1)(A) was ambiguous on its face and that a literal reading was unwarranted in the light of the legislative history of the section. The Court went into a lengthy examination of the history of 8(b)(1)(A), focusing its main attention on the Senate debates concerning the scope of 8(b)(1)(A) and the meaning of the proviso. The Court found that "the proviso preserves the rights of unions to impose fines as a lesser penalty than expulsion. . . ."<sup>33</sup> The Court concluded that the general history of congressional action in this area compelled the finding that these fines were internal union regulations which Congress had not attempted to restrict.<sup>34</sup>

It is important now to consider the context in which the Court allowed the fines to be imposed.

The Court generally followed the policy position that it was of greater importance for a union to be able to maintain internal discipline by fining strike breakers, than it was to allow individual union members unrestrained freedom to exercise Section 7 rights.<sup>35</sup> The majority took the position that since a union's major weapon was the strike, allowing a member to cross a picket line and go to work would, in effect, flout the will of the majority of union members who had voted to strike. The Court asserted that to permit discipline only in the form of expulsion or suspension (methods clearly within the proviso's

31. *Id.* at 661.

32. 388 U.S. 175 (1967).

33. *Id.* at 191-92.

34. See *A.O. Smith Corp. v. NLRB*, 343 F.2d 103 (7th Cir. 1965); *Majestic Molded Prods., Inc.*, 143 N.L.R.B. 71 (1963), *enforced*, 330 F.2d 603 (2d Cir. 1964); *Minneapolis Star & Tribune Co.*, 109 N.L.R.B. 727 (1954).

35. See generally Summers, *Legal Limitation on Union Discipline*, 64 HARV. L. REV. 1049 (1951).

language "acquisition or retention of membership"<sup>36</sup>) was not enough. The unions also needed the power of the fine. If a weak union could resort only to expulsion or suspension to enforce its rules, it would be faced with having to condone disobedience in order to prevent further depletion of its ranks.

The Court saw no difference between a court-enforceable fine and one that could be eventually enforced by the union through expulsion for non-payment. The Court brought both enforcement techniques under the protection of the proviso. The existence of a union security clause, a fact which had weighed heavily in the Seventh Circuit's decision, held no significance for the majority. After finding that the union members involved enjoyed full union membership, the Court refused to decide whether fines would be permitted had the membership been limited solely to the obligation of paying monthly dues.<sup>37</sup>

Justice Hugo Black, who wrote the dissenting opinion, asserted that the majority ignored the plain meaning of Section 8(b)(1)(A) in order to effectuate "its policy judgment that unions, especially weak ones, need the power to impose fines on strike-breakers and to enforce those fines in Court."<sup>38</sup>

The dissent stated that the majority committed a fundamental error in failing to distinguish between court-enforced fines and those enforceable by expulsion.<sup>39</sup> It asserted that the threat of a large court-enforced fine in some cases would absolutely restrain the employee from going to work, even if he were willing to work and risk union expulsion. The coercive nature of this action would have a direct effect on an employee's job rights—preventing him from working at all.

The dissent noted that one of the principal thoughts contained in the Senate debates on 8(b)(1)(A) was that its pur-

36. 29 U.S.C. § 158(b)(1)(A) (1964).

37. See *Radio Officers Union v. NLRB*, 347 U.S. 17, 41 (1954). The Court stated:

[L]egislative history clearly indicates that Congress intended to prevent utilization of union security agreements for any purpose other than to compel payment of union dues and fees.

It would seem that judicially enforced payment of a fine is considerably more than "payment of union dues and fees."

38. 388 U.S. 175, 201 (1967) (dissenting opinion).

39. As one writer has pointed out, this distinction is particularly applicable when applied to the union shop versus open shop controversy. For if in a union shop fines may be enforced by court action, then the open shop has a definite advantage in that only those belonging to a union could be fined. See Note, *Union Disciplinary Power and Section 8(b)(1)(A) of the National Labor Relations Act; Limitation on the Immunity Doctrine*, 41 N.Y.U.L. REV. 584 (1966).

pose was to prohibit union conduct that would be an unfair labor practice if engaged in by an employer. It contended that to hold that the words "restrain or coerce" mean something different when applied to unions than to employers was incongruous.

Finally the dissent warned that the majority's failure to decide whether 8(b)(1)(A) prohibits a union from firing an employee who merely pays dues "makes it highly dangerous for an employee in a union shop to exercise his Section 7 right to refrain from participating in a strike called by a union in which he is a member by name only."<sup>40</sup>

It is difficult to determine the extent to which organized labor will use the court-enforced fine. Certain members of Congress have already expressed disapproval of the Supreme Court's interpretation of 8(b)(1)(A).<sup>41</sup> It is submitted that the Court's over-balance of interests in favor of added union power at the expense of individual employee rights, is highly inconsistent with the "protective guardian" approach it has taken in regard to individual rights granted by the first ten amendments. Has the Court, as Justice Black suggests,<sup>42</sup> written a new proviso to 8(b)(1)(A)?

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40. 388 U.S. 175, 216 (1967).

41. See 66 L.R.R. 126 (Oct. 16, 1967), which reports an amendment made by the Senate Judiciary Subcommittee to a civil rights bill (H.R. 2516), passed by the House which reads as follows:

Sec. 104. Section 8(b)(1)(A) of the National Labor Act, 29 U.S.C. Sec. 158(b)(1)(A) is amended by striking out the semicolon at the end of the proviso and inserting in lieu thereof a colon and the following: *'Provided further, That nothing in this paragraph shall be construed to permit any labor organization or its agents to impose or any court to enforce any fine or other economic sanction whatever against any member who elects not to participate in any strike or other concerted activity in accordance with the rights vested in him by Section (29 U.S.C. 159).'*

42. "What the Court does today is to write a new proviso to Sec. 8(b)(1)(A): 'this paragraph shall not impair the right of a labor organization nonarbitrarily to restrain or coerce its members in their exercise of Sec. 7 rights.'" NLRB v. Allis-Chalmers Mfg. Co., 388 U.S. 175, 213 (1967).

South Carolina Law Review, Vol. 20, Iss. 1 □, Art. 6  
**MUNICIPAL CORPORATIONS—INDUSTRIAL REVENUE  
BONDS—SOUTH CAROLINA'S ENABLING ACT  
DECLARED CONSTITUTIONAL\***

I. INTRODUCTION

At the instance of the governor,<sup>1</sup> and faced with the incontestable necessity for stimulating industrial growth in South Carolina, the South Carolina General Assembly approved the Industrial Revenue Bond Act.<sup>2</sup> The express purpose of the Act was to enable public agencies<sup>3</sup> of the State to render assistance to new or expanding enterprises through the use of tax-exempt revenue bonds. The development of this type of financing program by more than thirty states<sup>4</sup> evidenced the importance of this legislation. The noted success of the device and this state's transition from agriculture to industry compelled its passage by the legislature. Having received legislative approval, the validity of the Act depended upon its conformity with particular federal standards<sup>5</sup> and the favorable ruling on state constitutional grounds which came in *Elliott v. McNair*.<sup>6</sup> An analysis of the Act, applying the federal qualifications and a consideration of the issues presented in *Elliott*, indicates compliance with all requirements.

II. THE FEDERAL STANDARDS

The Internal Revenue Code excludes from gross income "interest on the obligations of a State, a Territory, or a possession

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\* *Elliott v. McNair*, 156 S.E.2d 421 (S.C. 1967).

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1. In his "state of the State" address to the Joint Assembly, Governor Robert E. McNair emphasized the need for positive legislation concerning industrial financing saying, in part,

that the use of tax-exempt revenue bonds has reached the stage where South Carolina may soon become an island in the Southeast. With the knowledge that major corporations looking at South Carolina are being swayed in their decision by the availability of this kind of financing elsewhere, I recommend the passage of legislation permitting the kind of revenue bond financing that will allow us to remain competitive. 1 S.C. H.R. JOUR. 144-45 (1967).

2. LV S.C. STATS. AT LARGE 120 (No. 103, 1967) (hereinafter cited as the Act).

3. The "public agency" empowered to act in South Carolina is the County Board. LV S.C. STATS. AT LARGE 120 § 2 (No. 103, 1967).

4. For general historical development through 1966 see 7 B.C. IND. & COM. L. REV. 696 (1966).

5. Rev. Rul. 63-20, 1963-1 CUM. BULL. 24.

6. 156 S.E.2d 421 (S.C. 1967).

of the United States, or any political subdivision of any of the foregoing, or the District of Columbia.”<sup>7</sup> This exclusion has been interpreted as applying to the interest on bonds properly issued by “a duly organized political subdivision acting by constituted authorities empowered to issue such obligations . . . [as obligations *on behalf of* the] State, Territory or possession of the United States or political subdivision thereof.”<sup>8</sup> Under this treasury regulation, “[t]he term, ‘political subdivision’ . . . denotes any division of the State . . . to which has been delegated the rights to exercise part of the sovereign power of the state . . . .”<sup>9</sup> The Internal Revenue Service considers obligations of a nonprofit corporation, organized pursuant to the general nonprofit corporation laws of a state, as issued “on behalf of” the state if each of the following five requirements are met: (1) the activities of the corporation must be essentially public in nature; (2) the corporation must not be organized for profit—except for the retirement of indebtedness; (3) the corporate income must not inure to private persons; (4) the state or political subdivision must have a beneficial interest for the duration of the indebtedness and must gain full legal title upon retirement of indebtedness to the property for which the indebtedness was incurred; and (5) the state or its political subdivision must approve the corporation and the specific obligations issued by the corporation.<sup>10</sup>

7. INT. REV. CODE of 1954, § 103(a)(1).

8. Treas. Reg. § 1.103-1 (1956) (emphasis added).

9. *Id.*

10. Rev. Rul. 63-20, 1963-1 CUM. BULL. 24. Several revenue rulings favorable to this type of financing demonstrate the application of these criteria and reflect the current attitude of the Internal Revenue Service.

Rev. Rul. 54-296, 1954-2 CUM. BULL. 59. The beneficial interest for the duration of the indebtedness may be in the form of ownership of all of the capital stock of the nonprofit corporation, as when the municipality leased a municipally-owned building to a nonprofit corporation in exchange for all of its capital stock. The corporation then proposed to issue bonds to make improvements. The beneficial interest of the municipality consisted of retention of legal title to the property, ownership of all the capital stock, and contract rights whereby the municipality could acquire the improvements by discharging the corporate indebtedness.

Rev. Rul. 59-41, 1959-1 CUM. BULL. 13. A contract right alone is sufficient to establish a beneficial interest. A municipality entered into a contract with a nonprofit corporation organized under the general nonprofit corporation laws of the state and ratified and approved a purchase of a water system by the corporation and the issuance of bonds for this purpose. By the terms of the contract the municipality could purchase the water system for the amount of indebtedness outstanding. In both of the above cases the municipality became absolute owner of the property upon retirement of the indebtedness.

Rev. Rul. 57-187, 1957-1 CUM. BULL. 65; and Rev. Rul. 60-248, 1960-2 CUM. BULL. 35 exempt the interest on bonds issued by a public corporation or corporate



The South Carolina enabling act was patterned closely after an Alabama statute<sup>11</sup> which had already gained federal approval, and differed only in the provisions peculiar to its application in this state. The Act empowered the County Board, the regular governing body of the several counties of the state,<sup>12</sup> to acquire, lease, and issue revenue bonds to defray the cost of acquisition, improvement and expansion of the industrial sites subject to the approval of the State Budget and Control Board. The selection of the county as the political subdivision of the state to issue bonds is significant not only as providing a natural, organized subdivision of the state, but also as a very definite factor in federal acceptance of the Act.<sup>13</sup> *Commissioner v. Shamberg's Estate*<sup>14</sup> suggested that a mere instrumentality which issued bonds, collected rentals and distributed payments of principal and interest would not qualify as an acceptable political subdivision. The County Board, however, qualifies as a corporation which carries out "a portion of those functions of the state which by long usage and the inherent necessities of the government have been regarded as public."<sup>15</sup> Recognition of the county as an appropriate political unit is evidenced by an excerpt from a letter to the County Board of Spartanburg County written by the chief of the Individual Income Tax Branch of the Internal Revenue:

The County is one of the 46 counties of the State of South Carolina and is a body politic and corporate. The County possesses sovereign powers granted by the Constitution of

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governmental agency organized according to state statutes; provided the particular purpose of their creation is to issue bonds to enable their carrying out of the declared purpose.

Rev. Rul. 54-106, 1954-1 CUM. BULL. 28, which sanctions bonds issued by or on behalf of a municipality for the acquisition and construction of municipally owned industrial plants for lease to private industry as obligations of a political subdivision within the meaning of section 22(6)(4) of the 1939 Internal Revenue Code [section 103 of the 1954 Code].

11. ALA. CODE ANN. tit. 37 § 815-830 (1949).

12. Under the terms of the Act, if any project is located in more than one county, the governing bodies of the several counties are empowered to work together.

13. "The selection of the county as the issuer of the bonds was one of the primary reasons South Carolina's proposal was accepted, while those of Louisiana and other states were not. Originally we had planned to subdivide the state into Industrial Development Board Units; perhaps, if we had taken this course our plan would have been rejected also." Interview with Robert E. McNair, Governor of the State of South Carolina, in Columbia, Dec. 8, 1967.

14. 144 F.2d 998 (2d Cir. 1944), cert. denied, 323 U.S. 792 (1945).

15. *Id.* at 1004.

the State of South Carolina and is a political subdivision of the State of South Carolina.<sup>16</sup>

### III. "EQUAL INCOMES SHOULD BEAR EQUAL LIABILITIES"

Though qualified and within federal standards, the industrial revenue bond has strong opposition. The exclusion of the interest on the bonds from gross income has been characterized as a "truckhole" in the tax law.<sup>17</sup> It has been suggested that the use of tax-exempt revenue bonds to promote private ventures will result in a competitive advantage for those firms which qualify to use this method of financing; *i.e.*, a disproportionate tax burden will have to be borne by those income producing activities which are inherently incapable of using the device.<sup>18</sup> There is some validity in this criticism. Some type of businesses will not be able to qualify for this funding. There will rarely be discrimination in funding, however, among competing businesses or industries. The more serious aspect of unfair competition is that industries financed by these tax-exempt bonds will accumulate more working capital on the savings resulting from lower interest rates paid on the bonds. Technically there will be a state subsidy to the industry's income amounting to the difference between the interest charged under the present tax exemption and the lowest interest rate obtainable from private sources.

Another basic tax principle, that "taxpayers in similar circumstances should have similar burdens," is offended by excluding the interest paid on revenue bonds in computing gross income. By purchasing these tax-exempt revenue bonds the taxpayer may avoid a portion of the tax burden which he would otherwise have to carry. It is arguable that this "loophole" could cause the ordinary taxpayer to lose respect for the tax system, the strength of which is fairness and equity among taxpayers.<sup>19</sup>

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16. Letter from Lester W. Utter to the County Board of Spartanburg County, Nov. 22, 1967, copy on file in Governor's office.

17. Spiegel, *Financing Private Ventures with Tax-Exempt Bonds: A Developing "Truckhole" in the Tax Law*, 17 STAN. L. REV. 224 (1965).

18. *Id.* at 225.

19. Kirby, *State and Local Bond Interest*, HOUSE COMM. ON WAYS AND MEANS, 1 TAX REVISION COMPENDIUM, 86th Cong. 1st Sess. 679 (Comm. Print 1959) (hereinafter cited as 1 TAX REVISION COMPENDIUM); Barkin, *Exclusion from Taxable Income of Interest on Municipal Bonds to Subsidize Industry Should Be Discontinued*, 1 TAX REVISION COMPENDIUM 729 (1959).

## IV. INTERGOVERNMENTAL IMMUNITY

Since 1819 when Mr. Chief Justice Marshall recognized "[t]hat the power to tax involves the power to destroy,"<sup>20</sup> the doctrine of intergovernmental immunity, although restricted,<sup>21</sup> has been jealously guarded. There is authority that, as a principle of constitutional construction, the doctrine should be narrowly construed. This argument reasons that the expansion of immunity of one government correspondingly curtails the sovereign power of the other to tax. When the immunity is invoked by an individual (or corporation), therefore, it operates for the benefit of the individual (or corporation) at the immediate expense of the taxing government; and without corresponding benefit to the government in whose name the immunity is claimed.<sup>22</sup> No one will dispute that the individual (or corporation) benefits. The argument loses some force, however, when it attempts to demonstrate the corresponding detriment to the federal government and to the county which has "lent" its immunity to the corporation. The industrialization of a shrinking agrarian society will operate to curb unemployment and generally stimulate the economic growth of the community. Each new job will produce taxable income and allow the state and federal government to cancel, at least theoretically, one relief check. The increased production of the expanding industries will give rise to an increase in taxable sales (a benefit to the state) and accordingly affect the taxable gross income of the industry. These factors should be weighed against the "loss" in revenue on these bonds.

At an early date *Weston v. Charleston*<sup>23</sup> recognized that an attempt by the state to tax the stock of the United States not only operated upon the contract between the government and the individual, but also affected the power to borrow money on the credit of the United States. Similarly, if the federal government imposed a tax on the income of revenue bonds, it would diminish one of the attractive features of the bonds—the tax exempt interest to large investors in high tax brackets. This

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20. *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 431 (1819).

21. *See, e.g., Helvering v. Gerhart*, 304 U.S. 405 (1938) (federal income tax on salaries of employees of state government not unconstitutional); *Graves v. New York ex rel. O'Keefe*, 306 U.S. 466 (1939) (State income tax on salary of federal employees ruled not an unconstitutional burden).

22. *Graves v. New York ex rel. O'Keefe*, 306 U.S. 466, 483 (1939).

23. 27 U.S. (2 Pet.) 449, 468 (1829).

would decrease the impetus for industries to expand and accept these offers in a ratio inversely proportional to the increased cost of funding.<sup>24</sup>

This type of "non-profit lessor" financing (*i.e.*, one in which the county makes no profit on the sale of the tax-exempt bonds) should be distinguished from cases in which the state has more of a proprietary interest and a profit motive is involved.<sup>25</sup> The authority for state exemption from federal taxation in this situation, is found in *Pollock v. Farmers Loan & Trust Company*.<sup>26</sup> The case held that the federal government lacked the power to tax the property or revenues which the state collected from state securities. Affirming the decision upon rehearing, the Court stated:

We have unanimously held in this case that so far as this law operates on the receipts from municipal bonds it cannot be sustained, because it is a tax on the power of the states, and on their instrumentalities to borrow money and consequently repugnant to the constitution.<sup>27</sup>

24. See generally Ely, *Federal Taxation of Interest Paid by States and Political Subdivision upon Their Obligations*, 1 TAX REVISION COMPENDIUM 784 (1959).

25. See *South Carolina v. United States*, 199 U.S. 437, 463 (1905). A federal tax on the sale of liquor in state owned stores operated by agents of the state was upheld. The Court stated:

It is reasonable to hold that, while the former [federal government] may do nothing by taxation in any form to prevent the full discharge by the latter [state government] of its governmental functions, yet, whenever a state engages in a business which is of a private nature, that business is not withdrawn from the taxing power of the nation.

See also *New York v. United States*, 326 U.S. 572 (1946). The state of New York, in selling bottled mineral waters taken from springs owned by the state, was not immune from a nondiscriminatory federal excise tax on soft drinks.

26. 157 U.S. 429, *aff'd on rehearing*, 158 U.S. 601 (1895).

27. *Id.* at 630. This position was strongly supported by the other Justices, who dissented on other grounds. *Id.* at 652 (Justice White's dissent):

In regard to the right to include in an income tax the interest upon the bonds of municipal corporations, I think the decisions of this court, holding that the federal government is without the power to tax the agencies of the state government, embrace such bonds, and that this settled line of authority is conclusive on my judgment here. It determines the question that where there is no power to tax for any purpose whatever, no direct or indirect tax can be imposed.

*Id.* at 654 (Justice Harlan's dissent):

[M]unicipal corporations, exercising powers and holding property for the benefit of the public—are not subjects of national taxation in any form or for any purpose, while the property of private corporations and of individuals is subject to taxation by the general government for national purposes. So it has been frequently adjudged and the question is no longer an open one in this court.

Since the federal government has never successfully taxed the interest paid on the bonds of the states or their political subdivisions, a continuation of this policy will in no way "erode" the present federal tax base. To propose a change would be to propose federal encroachment on the borrowing power of the states. The increased burden on the political subdivision would be tantamount to a federal surcharge on the local government's taxes and rates for service.<sup>28</sup> The twin powers of the purse, to borrow and to tax, are delegated to the federal government in article I, section 8, of the Constitution. They are reserved to the states by the tenth amendment.<sup>29</sup> To the extent that their borrowing power is curbed by federal taxation, local governments become unable to shoulder their own financial burden and must turn to the federal government for assistance. The increased dependence on the federal government will be reflected in a heavier federal tax burden to defray the cost of local projects priced out of range of the state's borrowing power. The national interest is benefitted by the states, shouldering their own financial burdens.

#### V. APPROVAL OF THE ACT IN SOUTH CAROLINA

The courts in South Carolina have narrowly construed the power of political subdivisions to engage in financial operations when the object to be subserved was not of an essentially public nature.<sup>31</sup> In *Haesloop v. Charleston*<sup>32</sup> the court observed:

[S]uch benefits from a proposed expenditure as will accrue from increased taxable values, from enhancement of values generally, and from increased impetus to the commercial life of the community will ordinarily be considered of too incidental or secondary a character to justify the outlay of public funds.<sup>33</sup>

Recently the "public use" doctrine was discussed in *Edens v. City of Columbia*.<sup>34</sup> Upon examining the concept of eminent domain, the court indicated a continuing trend toward a restricted definition of "public nature."

28. Ely, *Federal Taxation of the Interest Paid by States and Political Subdivisions upon Their Obligations*, 1 TAX REVISION COMPENDIUM 783 (1959).

29. *Id.* at 789.

30. *Id.* at 790-91.

31. *E.g.*, *Bolton v. Wharton*, 163 S.C. 242, 161 S.E. 454 (1931).

32. 123 S.C. 272, 115 S.E. 596 (1923).

33. *Id.* at 286, 115 S.E. at 601 (emphasis added).

34. 228 S.C. 563, 91 S.E.2d 280 (1956).

Why then, in *Elliott v. McNair*,<sup>35</sup> did the South Carolina Supreme Court seemingly broaden its heretofore narrow interpretation of "public nature"? First, the court was influenced by the action of the legislature upon the enabling legislation. Although the tax-exempt bonds are to be sold to finance private industry, the General Assembly characterized this issuance as a "public purpose." It has been recognized that the question of whether an act is for a public purpose is primarily for the legislature.<sup>36</sup>

The legislative determination that the promotion of industrial development is for public purpose and thus a proper government function is presumed to be correct. . . . Courts cannot interfere with what the General Assembly has declared to be a public purpose and thus a function of the government unless the judicial mind conceives that the legislative determination is without reasonable relation to the public interest or welfare and is beyond the scope of legitimate government.<sup>37</sup>

The Supreme Court, moreover, has refused to interfere with a state's determination of what constitutes a public purpose.<sup>38</sup>

In *Elliott* the court stated that it should never invalidate an act of the General Assembly unless it was offensive to specific provisions of the state constitution. Article 10, section 6 of the constitution strictly limits the powers of a county to levy taxes and issue bonds.<sup>39</sup> In light of past decisions, however, this limitation applies solely to general obligation bonds payable from the proceeds of *ad valorem* tax levies.<sup>40</sup> The proposed revenue bonds, payable solely from rentals received, are not affected.

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35. 156 S.E.2d 421 (S.C. 1967).

36. See, e.g., *McNulty v. Owens*, 188 S.C. 377, 199 S.E. 425 (1938); *Green v. City of Rock Hill*, 149 S.C. 234, 147 S.E. 346 (1929). See also *Fairfax County Indus. Dev. Authority v. Coyner*, 207 Va. 351, 150 S.E.2d 87 (1966).

37. *Fairfax County Indus. Dev. Authority v. Coyner*, 207 Va. 351, 357, 150 S.E.2d 87, 93 (1966).

38. *Green v. Frazier*, 253 U.S. 233 (1920).

39. S.C. Const. art. 10, § 6, provides in part:

The General Assembly shall not have the power to authorize any county or township to levy a tax or issue bonds for any purpose except for educational purposes, to build and repair public roads, buildings and bridges, to maintain and support prisoners, pay jurors, County officers, and for litigation, quarantine and court expenses, and for ordinary county purposes, to support paupers and pay past indebtedness.

40. *Benjamin v. Housing Authority*, 198 S.C. 79, 15 S.E.2d 737 (1941); *Park v. Greenwood County*, 174 S.C. 35, 176 S.E. 870 (1934).

Finally, the bonds will not affect the credit of the state since they are not constitutional debts within article 10, Section 6.<sup>41</sup>

The South Carolina enabling act allows the bonds to be secured by a trust indenture. The contention has been raised that the county might use publicly owned property upon which to locate the industry. If the industry defaulted on its payments to the county, the Act might expose publicly owned property to a mortgage foreclosure sale. *Clarke v. South Carolina Public Service Authority*,<sup>42</sup> however, has already resolved the contention, holding that there is no constitutional objection if the mortgage is limited to the property purchased rather than to previously owned public lands. The Act clearly provides, moreover, that only property purchased from the proceeds of revenue bonds will be mortgaged, and that no property now owned by the county or to be acquired by taxation will be affected.<sup>43</sup>

The appellant in *Elliott* contended that to allow certain private corporations to borrow money at lower interest rates than those whose loans were not secured by tax exempt bonds, violated the equal protection clause of the constitution.<sup>44</sup> There is no violation, however, if an act applies equally to all the constituents of a designated class, and the classification is reasonably related to the legislative intent.<sup>45</sup> Further arguing under article 1, section 5 (due process clause) and under article 3, section 31 (public land clause), the appellant asserted that the provisions of the Act relating to purchase or release of the industrial facilities at a nominal sum were unconstitutional. The court declared, in direct conflict with plain constitutional language, that public agencies should be allowed to exercise discretion and weigh indirect benefits to the public in their decision.<sup>46</sup> In all probability, however, this will become academic as

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41. See, e.g., *Duke Power Co. v. Greenwood County*, 19 F. Supp. 932 (1932); *Benjamin v. Housing Authority*, 198 S.C. 79, 15 S.E.2d 737 (1941); *Park v. Greenwood County*, 174 S.C. 35, 176 S.E. 870 (1934).

42. 177 S.C. 427, 181 S.E. 481 (1935).

43. LV S.C. STATS. AT LARGE 120, § 5 (No. 103, 1967).

44. S.C. CONST. art. 1, § 5.

45. *Duke Power Co. v. Bell*, 156 S.C. 299, 152 S.E. 865 (1930).

46. S.C. CONST. art. 3, § 31, declares that land shall not be sold to corporations "for a less price than that for which it can be sold to individuals." Perhaps this decision would be more palatable if this "judicial legislation" were cured by constitutional amendment.

the "nominal sum," purchase or release provision will soon reflect approximate market value.<sup>47</sup>

Although South Carolina's enactment was preceded by similar legislation in approximately forty states, it is unique in at least one of its provisions. Because the property acquired by the bonds technically became property of the state or its political subdivision, it has never been subjected to *ad valorem* taxes, thereby depriving the subdivision of revenue. Section 6 of the Act accomplishes this object by requiring that each lease contain a provision whereby the lessor shall, in lieu of these taxes, pay to the political unit in which the project is located that amount which *would have* been levied on the property had the lessor been owner.<sup>48</sup>

## VI. CONCLUSION

In considering the future of industrial revenue bonds, it should be recognized that the increasing popularity and use of this type of financing increases the opposition to it on the federal level. The federal government will not allow continued subsidy to private industries at what it terms its own expense. The continued abuse of the bonds, through encouraging industrial growth in areas where labor is already in short supply, or when the "public purpose" is not served,<sup>49</sup> may bring about control by the Treasury Department whose interest lies in preserving the tax base rather than developing the revenue bond

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47. From interview with Robert E. McNair, *supra* note 14:

Q. Exactly what is meant by "a nominal sum" in the Act; that is, will one dollar qualify as a nominal sum.

A. (Governor McNair) I cannot say precisely what will qualify as a nominal sum, but, I can assure you that our interpretation will be acceptable to federal guidelines which are forthcoming from the Internal Revenue Service. Subsequent to the approval of our enabling act an entire new slate of requirements pertaining to this type of bond issue was promulgated, but to my knowledge no printed copies are available presently.

48. This amount is to be computed exactly as if the *ad valorem* tax were being levied, taking into account all deductions and tax exemptions.

49. *Industrial Aid Bonds*, FEDERAL RESERVE BANK OF RICHMOND MONTHLY REVIEW 11 (Jan. 1967).

Two specific practices have been singled out for much criticism. One is the purchase by the corporation of the municipal bonds which were sold for its benefit. It has been argued that if the company could afford to purchase its own bonds, it could have provided its own financing. Second is the sale of bonds to purchase an *existing* facility which is then leased back to the corporation already using the facility. This amounts to a refinancing scheme using tax exempt bonds, since no new jobs are created.



program.<sup>50</sup> It has been suggested that some sort of "purpose test" be applied to insure that the activities of the state or its political subdivision are primarily implemented and furthered rather than some private, outside interest.<sup>51</sup> The Internal Revenue Service has adopted a broad interpretation of what is beneficial public activity under Revenue Ruling 63-20.<sup>52</sup> Several questions are raised by the proposal of such a test: (1) Who would determine the status of each bond issue? (2) Would the determination be made before or after the issue of the bonds? (3) Would a delay to await a ruling, or between the ruling and an appeal, not destroy a part of the utility of this bond? Although these questions pose complex problems, some type of solution must be sought. Some means of federal control, via Congress or the Treasury Department, is inevitable if the states do not effect control on their own; best estimates predict a change to be effected sometime in 1969 (due in part to 1968 being an election year).<sup>53</sup>

In the face of almost certain change, the question presents itself: How will South Carolina be affected? While the advantageous aspects of industrial bond financing have been recognized in this state, a change "across the board" would, in absence of retroactive effectiveness (probably unconstitutional) have little effect on this economy. South Carolina will maintain a relatively stable economic position regarding any change which will be applied universally.<sup>54</sup>

After being backed into a corner, the State was forced to adopt the Act to remain competitive with its neighbors. Having thus placed itself on an equal footing, South Carolina has again become actively engaged in the "New War Between the States" for creating and expanding industry.

#### NOTE

Effective March 15, 1968 the industrial revenue bond was banned by a ruling of the Internal Revenue Service. The ruling was rescinded on March 19, 1968 after a bill to legalize the tax-

50. See generally 7 B.C. IND. & COM. L. REV. 696, 703-04 (1966).

51. Spiegel, *supra* note 18, at 240.

52. Rev. Rul. 63-20, 1963-1 CUM. BULL. 24.

53. Interview with Fred R. Sheheen and Sloan Gable, State Development Board, in Columbia, S.C., Dec. 11, 1967.

54. *Id.*

free financing was introduced in the United States Senate. This ruling was indicative of the sentiment of the Treasury Department, and should serve as a further warning to the states to adopt some measure of uniform control in this area.

J. HAMILTON STEWART, III

**PROCESS OF POSTING NOT COMPLETE**

**UNTIL MIDNIGHT DEADLINE\***

"An ordinary lay person might reasonably ask . . . just when an item was 'paid' and reasonably expect that some sort of an answer could be given."<sup>1</sup>

This was the precise question presented to the Wisconsin Circuit Court in *West Side Bank v. Marine National Exchange Bank*. On a Thursday in August, 1966, the Paine Webber Corporation drew a check on Marine for \$262,000.00 to one Swidler, who deposited it on the same day at West Side. The next morning West Side presented the check to Marine through the Milwaukee clearing house. That night the check was charged to Webber's account during the computer run. On Monday, the next business day, the posting continued and the item was photographed, stamped "paid", cancelled and placed in the drawer's file.

On Monday afternoon a check for \$270,000.00 from Swidler to Webber was returned to Marine because of insufficient funds. Upon notification of the dishonor that same afternoon, Webber issued a stop payment to Marine on its check. Marine notified West Side by telephone, withdrew the item from Webber's file, credited the account in the Monday night computer run, and on Tuesday morning returned the check.

West Side contended that Marine had "paid" the item and could not revoke its settlement. Applying sections 4-213(1) (c), (d) and 4-109 of the Uniform Commercial Code the court held that an item was not paid until the statutory time in which a settlement could be revoked had elapsed.<sup>2</sup> The plaintiff's motion for a summary judgment was denied.

Before discussing the concept of final payment under the Uniform Commercial Code, it is necessary to explain briefly the significance of final payment in banking usage and the state of the law concerning payment prior to the adoption of the Uniform Commercial Code.

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\* *West Side Bank v. Marine Nat'l Exch. Bank*, Case No. 341-852 (Wisc. Cir. Ct., April 20, 1967).

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1. Malcolm, *Article 4—A Battle With Complexity*, 1952 WIS. L. REV. 265, 288.

2. See UNIFORM COMMERCIAL CODE § 4-301.

When a customer deposits a check in his account at a bank, the item is treated as if it were cash and a credit is entered. In the same manner, each bank that handles the check until it is paid will credit its immediate transferor in the collection chain upon receipt of the item. The line of credits that result are tentative in nature and become final only when the drawer's bank pays the item.<sup>3</sup> Naturally, if the drawee bank refuses to pay, the credits are reversed. When final payment occurs, the drawer's liability on the item is replaced by that of his bank.<sup>4</sup> This practice has long been used by the banks and is recognized and codified by the Code.<sup>5</sup>

Aside from its application to collection and settlement, the concept of payment is also important when the priority of claims to the balance of the drawer's account is in issue. There is a point after which one of the "four legals", seeking to affect the account or the payment of the check, comes too late to prevent the depositor's interest from being defeated.<sup>6</sup> Unfortunately, this point is also called payment and since it is generally a point sooner in time than the collection "payment", there is an inherent confusion.

The Uniform Commercial Code has continued this dichotomy in sections 4-213 and 4-303. The latter section utilizes the same tests as 4-213 to determine the "priority status" of competing claims but applies additional tests. In addition there is "payment" as used to determine the risk of loss on the failure of the payor bank<sup>7</sup> and the rule that a check is considered paid if not returned by the payor bank within a certain period of time.<sup>8</sup> The complexity of the situation leads to the query "When is an item paid?" The importance of determining an answer, both for the customer and banker, is apparent.

The fixed time standard is appealing because of its evident ease of application. The length of time should be long enough

3. Malcolm, *supra* note 1, at 269.

4. See A.B.A. BANK COLLECTION CODE § 3. The text of the act is set forth at 2 PATON'S DIGEST 1373-75 (1942).

5. See, e.g., UNIFORM COMMERCIAL CODE §§ 4-212, 4-301.

6. Leary, *Check Handling Under Article Four of the Uniform Commercial Code*, 49 MARQ. L. REV. 331, 362 (1965). The four legals are stop order of the drawer; legal process affecting the account; drawee bank's right of set-off; and notice of death or incompetence of the drawer.

7. Leary, *Deferred Posting and Delayed Returns—The Current Check Collecting Problem*, 62 HARV. L. REV. 905, 940 (1949).

8. *Id.* at 947. For a summary of the difficulty of a single time concept of payment see *id.* at 955.

to allow the payor bank to process and verify the item and decide whether to pay it. Section 137 of the N.I.L. gave a drawee bank twenty-four hours to revoke a credit.<sup>9</sup> If the drawee failed to revoke within this time, it was considered to have paid the item and became liable therefor. At common law the majority rule varied slightly from the position in the N.I.L.<sup>10</sup> When the payee's account was at the same bank as the payor's and a credit was given in the payee's passbook for the item, unless there was some agreement to the contrary, final payment had occurred.<sup>11</sup> Since the bank knew its customers' accounts, it was unnecessary to extend payment time beyond entry of the credit to the payee's account.

As the volume of checks grew, a longer period of time was needed in which a payor bank could decide to pay an "on-us" item. The ABA Collection Code, section 3,<sup>12</sup> extended this time to the end of the business day of receipt.

With the coming of the Second World War, both the number of checks and the manpower shortage demanded an extended period of time for posting.<sup>13</sup> Consequently, nearly all jurisdictions adopted some form of legislation permitting deferred posting.<sup>14</sup> The Federal Reserve regulations made similar allowances.<sup>15</sup> Generally, the decision to revoke credits had to be made by midnight of the next business day.<sup>16</sup>

While the midnight deadline was the latest time at which an item could be considered paid, an earlier point of payment was based on some action of the payor bank with respect to the item.<sup>17</sup> There was wide difference of opinion, however, concerning which action would constitute payment.

9. For a notable application of N.I.L. § 137, see *Wisner v. First Nat'l Bank*, 220 Pa. 21, 68 A. 955 (1908).

10. See *Oddie v. National City Bank*, 45 N.Y. 735 (1871).

11. As to what constitutes sufficient agreement see *Ryan v. Columbia Nat'l Bank*, 142 S.C. 231, 140 S.E. 593 (1927), in which the terms on a deposit slip were held not binding on the customer without a showing of his knowledge and consent thereto; cf. *E.S. Macomber & Co. v. Commercial Bank*, 166 S.C. 236, 164 S.E. 596 (1932).

12. 2 PATON'S DIGEST 1373 (1942).

13. CLARKE, BAILEY & YOUNG, BANK DEPOSITS AND COLLECTIONS 84 (1959).

14. See, e.g., S.C. CODE ANN. § 8-211 (1962).

15. 12 C.F.R. § 210.5 Reg. 5 (1939), as amended, 13 F.R. 7296 (1948); 25 F.R. 10495 (1960); 29 F.R. 12361 (1964).

16. See MODEL DEFERRED POSTING STATUTE, cited in E. FARNSWORTH, CASES AND MATERIALS ON NEGOTIABLE INSTRUMENTS 321 (1959).

17. See generally 1 PATON'S DIGEST 1065 (1942); Andrews, *The City Clearing House: Payment, Returns, and Reimbursement*, 27 INDIANA L. J. 155 n. 28 (1952).

Most jurisdictions agreed that payment by cash was final.<sup>18</sup> Some courts, however, framed the issue in terms of the intent of the parties and subjected the facts to a jury for their determination.<sup>19</sup>

The issuance of remittance drafts by the payor bank was the center of an attempt to pinpoint payment. Drawing by the payor bank of the remittance draft was generally held not to constitute final payment.<sup>20</sup> Others held that receiving the draft was payment.<sup>21</sup> Because a draft could be retrieved from the mail, one court found that mailing the item did not constitute final payment.<sup>22</sup>

Focusing on the steps of the payor's posting of the item, a number of points were considered as marking payment. Stamping the check "paid" was rejected as constituting payment by most courts.<sup>23</sup> Most courts, moreover, rejected certain preliminary steps which had no relationship to a decision to pay. Usually the posting to the drawer's account was deemed determinative of the bank's intention to pay.<sup>24</sup>

As the pre-Code cases indicate, "payment" is not one point in time. It is rather a concept used to fix liability for an item; and it often depends on the identity of the contesting parties. The Code makes a distinction between final payment when the issue arises as to the liability of the payor bank and the collection process,<sup>25</sup> and when the issue is whether one of the "four legals" has come to the payor bank in time to defeat the depositor's interest in the item.<sup>26</sup>

18. *Bellevue Bank v. Security Nat'l Bank*, 168 Iowa 707, 150 N.W. 107 (1915); *Fidelity & Cas. Co. v. Planenscheck*, 200 Wis. 304, 227 N.W. 387 (1929).

19. From certain facts, as a matter of law, only one conclusion may be drawn. Because of the volume and mechanization of modern checking, a factual standard, such as debiting the drawer's account, is far more workable than the jury's conclusions as to the parties' intent. *See Andrews, supra* note 17, at 159. *See also American Nat'l Bank v. Miller*, 229 U.S. 517 (1913).

20. *Nineteenth Ward Bank v. First Nat'l Bank*, 184 Mass. 49, 67 N.E. 670 (1903).

21. *Dewey v. Margolis & Brooks*, 195 N.C. 307, 142 S.E. 22 (1928).

22. *Bohlig v. First Nat'l Bank*, 233 Minn. 523, 48 N.W.2d 445 (1951).

23. *First Nat'l Bank v. First Nat'l Bank*, 127 Tenn. 205, 154 S.W. 965 (1913). *But see First Nat'l Bank v. Wisconsin Nat'l Bank*, 210 Wis. 533, 246 N.W. 593 (1933).

24. *Hay & Stevens v. First Nat'l Bank*, 244 Ill. App. 286 (1927). *But see A.B.A. BANK COLLECTION CODE, supra* note 4.

25. *UNIFORM COMMERCIAL CODE* § 4-213; *see Leary, supra* note 6, at 362.

26. *UNIFORM COMMERCIAL CODE* § 4-303.

Under section 4-303(1)(d) the drawer's liability on the item is discharged when the payor bank "has evidenced by examination of such individual account and by action its decision to pay the item. . . ." This would normally be an earlier time than the point at which the drawer's liability is replaced by his bank's liability under 4-213. The basis of the difference is that the time allowed for deferred posting<sup>27</sup> is a convenience to the bank and should not enlarge the drawer's liability.

In *West Side v. Marine*, the issue was whether the payor's acts of photographing the item, stamping it "paid", cancelling and filing it constituted final payment under 4-213(2) of the Code, making the provisional credit given to West Side final.

That section provides:

4-213(2) If provisional settlement for an item between the presenting and payor banks is made through a clearing house or by debits or credits in an account between them . . . they become final upon final payment of the item by the payor bank.

Part one of the same section specifies when this final payment occurs.

4-213 (1) (A) An item is finally paid by a payor bank when the bank has done any of the following, whichever happens first:

- (a) paid the item in cash; or
- (b) settled for the item without reserving a right to revoke the settlement and without having such right under statute,<sup>28</sup> clearing house rule or agreement; or
- (c) *completed the process of posting the item* to the indicated account of the drawer, maker or other person to be charged therewith; or
- (d) made a provisional settlement for the item and failed to revoke the settlement in the time and manner permitted by statute, clearing house rule or agreement.

Upon a final payment under subparagraphs (b),(c) or (d) the payor bank shall be accountable for the amount of the item (emphasis added).

27. UNIFORM COMMERCIAL CODE § 4-301, Comment 1.

28. The statutory right to revoke a settlement is provided by UNIFORM COMMERCIAL CODE § 4-301.

It was West Side's contention that Marine had "completed the process of posting." The Uniform Commercial Code was amended in 1962 to define the "process of posting."

4-109. The "process of posting" means the usual procedure followed by a payor bank in determining to pay an item and in recording the payment including one or more of the following or other steps as determined by the bank:

- (a) verification of any signature;
- (b) ascertaining that sufficient funds are available;
- (c) affixing a "paid" or other stamp;
- (d) entering a charge or entry to a customer's account;
- (e) *correcting or reversing an entry or erroneous action with respect to the item* (emphasis added).

On the basis of subsection (e), the court determined that the "process of posting" was not completed until the statutory time for reversal of entries had expired. That time is the "midnight deadline"<sup>29</sup> referred to in sections 4-213(1)(d) and 4-301.

Before the addition of section 4-109, the "process of posting" was generally held to include two elements: (1) judgment of the payor bank as to the sufficiency of the account and the veracity of the item and; (2) a mechanical step of recording the decision to pay, usually by a debit of the account.<sup>30</sup> The entire tenor of the collection sections is based on the concept that "final payment occurs at some point in the processing of the item by the payor bank."<sup>31</sup> "If a payor bank has not previously paid an item in cash or finally settled for it, certain *internal acts or procedures* will produce final payment of the item."<sup>32</sup> If section 4-109(e) is interpreted to mean that the process of posting is completed only upon the expiration of the midnight deadline, it is obvious from the foregoing quotations that this section will not clarify the Code's use of the term. It will instead substitute a meaning for the process of posting which is at variance with the existing

29. UNIFORM COMMERCIAL CODE § 4-104(h) defines "midnight deadline" as midnight of the next banking day.

30. See UNIFORM COMMERCIAL CODE § 4-303, Comment 3. Ohio did not adopt § 4-109 and in *Gibbs v. Gerberich*, 1 Ohio App. 2d 93, 203 N.E.2d 851 (1964) the court determined that the process of posting was not completed until both the judgment and accounting steps were completed.

31. UNIFORM COMMERCIAL CODE § 4-213, Comment 2.

32. UNIFORM COMMERCIAL CODE § 4-213, Comment 5 (emphasis added).



law. The reporter states that, "[T]his section [4-109] defines what is meant by the 'process of posting.'"<sup>33</sup> He refers to section 4-213(1)(c) as an aid in the definition. The court's interpretation of 4-109(e), however, broadens the plain meaning attributed to 4-213(1)(c). The reference to it in 4-109, therefore, seems pointless as a definition of "process of posting." This would indicate that the "process of posting" definition should be interpreted to complement the Code's usage of the term instead of derogating it.

The court quoted in its decision portions of a law review article.<sup>34</sup> This article concludes that "in the absence of a provision to that effect [debiting the drawer's account is final payment] the rule [clearing house deadline] should be interpreted to mean that the check is not paid until the expiration of the return period."<sup>35</sup> Reliance upon this quoted proposition, however, does not seem justified since this case was argued on the Code and not on clearing house rules. The Uniform Commercial Code, moreover, makes a provision for final payment—completion of the process of posting.

The court interpreted section 4-109(e) to mean that any entry upon the drawer's account could be reversed before the "midnight deadline." It rejected an interpretation which would make "entry" mean only erroneous entry (*i.e.*, when the payor bank debited the account in an incorrect amount). The court, in effect, interpreted the terms "correcting" and "reversing" to allow a bank, either to correct an erroneous entry, "or" to reverse that entry for any reason, before the midnight deadline.<sup>36</sup> The court's interpretation will dilute section 4-213(1)(d) to near meaninglessness and create considerable inconsistencies in the other sections<sup>37</sup> dealing with the issue of final payment, as well as contradict the stated theory on which the sections are based. A statutory construction which will avoid these effects, therefore, does not seem unreasonable.

This could be accomplished by construing "correcting or reversing an entry" so as to make "reversing" a form of "cor-

33. UNIFORM COMMERCIAL CODE § 4-109, Comment.

34. Andrews, *supra* note 17, at 155.

35. *Id.* at 168; cf. Wallace, *Comments On the Proposed Uniform Check Collection Code*, 16 VA. L. REV. 792, 805 (1930).

36. This follows from an interpretation of "or" as used in the disjunctive sense. For an alternative statutory construction of the word "or" see 2 SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 4923 (3d ed. 1943).

37. UNIFORM COMMERCIAL CODE §§ 4-301, 4-303.

recting." The section, moreover, seems posited on the making of mistakes by the use of the word "correcting" which implies error and the word "erroneous." The phrase "correcting an entry" has its most obvious meaning, not as an obliteration of the entry, but rather as an alteration<sup>38</sup> of it. This would be the case as in the previous example in which the payor bank had debited the account in an incorrect amount. It would be unreasonable to presume that posting was then completed and that no further action could be taken. When the entry was completely erroneous the correction would be to reverse the entry. If 4-109(e) is so interpreted, the harmony of Article Four's treatment of collection is preserved.<sup>39</sup>

The last question raised by the case concerns the practical matter of allowing a payor bank a fixed amount of time in which to revoke its credits for any reason. Section 4-303 will partially protect the payee from the bank's use of the excess time to make itself a preferred creditor by means of a set-off. The drawer is likewise protected against the bank's dishonoring a check in order to secure its own rights against the account.<sup>40</sup> The query remains: "What will be the limit of the discretion given to the bank to revoke its credits within the fixed time period?" The bank does not become liable on the item until it is finally paid. So long as its customer (the drawer) agrees, it may defeat any interest of the owner (payee) within the time period, owing no legal obligation to anyone except the drawer.<sup>41</sup> This type of arrangement puts the owner in a position more vulnerable than the pre-Code law allowed.

This interpretation of section 4-109 has created a situation which was obviously not contemplated at the last draft of the Uniform Commercial Code. Barring a clarification in the Code itself, it will be up to the courts to determine whether section 4-109 should be blended into the general purpose of Article Four, or be the point of departure for a new body of law on the subject of final payment.

J. DAVID HAWKINS

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38. WEBSTER'S NEW INTERNATIONAL DICTIONARY (2d ed. 1936) lists the following synonyms for the word "correct": "amend, reform, remedy, better, improve."

39. See UNIFORM COMMERCIAL CODE § 1-102 (Subsection one has particular significance).

40. UNIFORM COMMERCIAL CODE § 4-402.

41. See Leary, *supra* note 6, at 364-65.